United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

74-2405

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Docket No. 74-2405

GERALD L. HERZFELD,

Plaintiff-Appellee,

against

LAVENTHOL, KREKSTEIN, HORWATH & HORWATH,

Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING AND SUGGESTION THAT THE REHEARING BE *IN BANC*

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Preliminary Statement

This case involves an appeal from an Amended Judgment entered against defendant-appellant and third-party-plaintiff-appellee Laventhol, Krekstein, Horwath & Horwath ("Laventhol") in the United States District Court for the Southern District of New York after trial before Hon. Lloyd F. MacMahon without a jury in favor of plaintiff-appellee Gerald L. Herzfeld ("Herzfeld") in the amount of $153,000 with costs and interest, upon a finding of liability under Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j (b)], Section 352-c of the General Business Law of the State of New York (McKinney's 1968) and the common law. On July 15, 1976, a three judge panel of this Court affirmed that Amended Judgment. Pursuant to Rules 35(b) and 40 of the Federal Rules of Appellate Procedure ("F.R.A.P."), Laventhol petitions this Court for a rehearing and respectfully suggests that such rehearing be in banc.

Issue on Rehearing*

Upon this Petition, Laventhol presents only one question: Did the panel of this Court correctly interpret and apply the doctrine of *Ernst & Ernst* v. *Hochfelder*, U. S. , 96 S. Ct. 1376, 47 L. Ed. 2d 668 (1976) to the accountants' liability case here involved?

Laventhol contends that the panel, which had the case under advisement when *Hochfelder* was decided, erred in both its interpretation of the *scienter* requirement announced by the Supreme Court, and in its application of that principle to accountants' liability cases.

Statement of the Case

This case involves the audit performed by Laventhol of the financial statements of the Firestone Group Limited (the "Firestone Group") for the period ending November 30, 1969. Firestone Group entered into a private placement of certain of its securities, inducing investors to participate by displaying to them certain unaudited financial statements and promising that, as a condition of closing, audited financial statements which conformed to the unaudited figures would be provided. Laventhol subsequently did audit the financial statements of Firestone Group and insisted that certain transactions which produced a material amount of revenue be treated in such a way as not to recognize in the current accounting period the vast majority of income derived therefrom. Laventhol qualified its opinion

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* In addition to the issue here presented, certain other questions were passed upon by the panel. These included an analysis of the financial statements leading to the panel's decision, on grounds different from those arrived at by the District Court, that they were misleading, and a holding that under the circumstances the requirements of reliance and causation in fact had been satisfied. With both of these conclusions, petitioner emphatically disagrees, and in presenting this single issue for rehearing does not abandon its position on them. Likewise, petitioner does not raise for rehearing any issues related to the companion appeal, involving contribution between it and certain third-party defendants, which was decided in the same opinion.

on the financial statements in light of its concern about the collectibility of the deferred portion of the income.

Although the audited financial statements were recognized by Firestone Group and its agent, Allen and Company, as not being in conformity with the unaudited financial statements, the private placement was closed. The participants were thereafter furnished with the Laventhol report and a letter sent by the issuer and found by the District Court to be misleading, the plain design and effect of which was to disguise the disparity between the unaudited Firestone Group figures and the audited figures reported on by Laventhol.

Herzfeld was one of the investors and, without reading anything except the income statement of the report (and ignoring the Laventhol opinion and footnotes) he decided not to exercise a right to rescind his purchase which had been extended to him and others in Firestone Group's misleading letter.

The District Court found that the Laventhol report was misleading because it did not include a variety of facts, discovered in the course of its audit, which the District Court believed should have been presented to the investors to allow them to make judgments concerning the solidity of the key transactions reported on. The District Court further held that because the auditors knew these facts, their omission to state them was knowing and the *scienter* requirement was thus satisfied. After holding that Herzfeld should be construed as having relied on the Laventhol report, the Court entered judgment against Laventhol in his favor.

After this appeal had been briefed, argued and taken under advisement, the United States Supreme Court decided *Hochfelder, supra,* and held that *scienter,* as there defined, is a requisite element of pleading and proof in a claim for damages brought under Section 10(b).

On July 15, 1976, the panel of this Court* rendered an opinion affirming, on a substantially different analytical basis, the judgment of the District Court. The panel, in treating of *Hochfelder*, held that knowledge of facts which, in the Court's view, should have indicated a treatment of certain transactions different from that shown in the financial statements, was sufficient to make out the requisite *scienter*. The panel did not hold, the District Court did not find, and the record did not show that Laventhol's actions had been taken in bad faith, or that Laventhol was guilty of any intent to deceive, manipulate or defraud.

Laventhol contends that this holding is error, represents an inappropriate gloss on the *Hochfelder* rule, and unduly enlarges the scope of potential liability for accountants. As the first utterance of this Circuit since *Hochfelder*, on the question of the requisite *scienter* it not only works an incorrect result in this case, but establishes a mischievous authority in the area. Since the *Hochfelder* issue was not briefed and argued before the panel, petitioner submits that reexamination of this major point, upon full briefs and argument is in the interest of a just disposition of this case and the orderly development of precedent.

ARGUMENT

The panel misapprehended the *scienter* requirements as enunciated by the United States Supreme Court.

A. The Holding of Hochfelder

The Supreme Court granted certiorari in *Hochfelder:*

> "to resolve the question whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate or defraud . . . We conclude that it will not and therefore we reverse." 47 L. Ed. 2d at 677

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* Circuit Judges Moore and Timbers and District Judge Coffrin.

The Court considered whether *scienter* was indispensable and what the term embraced. Having decided that *scienter* was indispensable, the Court devoted most of its attention to its definition. In doing so, the Court examined the various formulations previously utilized by the circuit courts and held that " '*scienter*' refers to a mental state embracing intent to deceive, manipulate or defraud." (Id. at 677, n. 12).

In determining that such a fraudulent intent was required for recovery, the Court looked first to the language of the statute itself. It held that the use of words such as "manipulative or deceptive" and "device or contrivance", which it found strongly suggestive of a proscription against "knowing and intentional misconduct" (47 L. Ed. 2d at 179), did indeed connote "intentional or willful conduct *designed* to deceive or defraud investors." (emphasis added). (47 L.Ed. 2d at 680). Looking next to the legislative history, the Court concluded that Congress never intended liability to be imposed on anyone under Section 10(b) "unless he acted other than in good faith." (Id. at 684). Under *Hochfelder*, then, errors of judgment or of fact, negligence or mistake, do not create liability under Section 10(b); a plaintiff must plead, and, of course, prove "intentional or willful conduct designed to deceive" in order to recover.

B. Laventhol's Actions

While *Hochfelder* was a case involving the adequacy of an audit, the case before this Court involves the propriety of the opinion rendered, after audit, to the accounting treatment of certain transactions. The application of *Hochfelder* thus requires some analysis, for which, petitioner submits, full briefing and argument should be allowed. In substance, Laventhol's position is as follows.

Laventhol's actions here involved a two-step procedure: (a) the acquisition of knowledge of the relevant facts by

audit and (b) the making of a judgment in light of those facts as to the opinion it should render concerning the financial statements. Here, the relevant facts were those surrounding the purchase by the Firestone Group of certain parcels of real property from a group known as Monterey Nursing Inns, Inc. ("Monterey") and the nearly simultaneous sale of the same properties by Firestone Group to Continental Recreation Company, Ltd. ("Continental") in November 1969.

The Monterey-Continental transactions represented a total profit to Firestone Group of $2,030,500. The record is clear that Laventhol (a) sought and obtained documentation for these transactions (554-558a, 915-918a),* (b) discussed the details of the transactions with Firestone Group officers (554-558a, 573a, 934-939a) and (c) obtained confirmation from Continental's principal officer that the sale would be consummated (827-829a).

Subsequent to gathering the relevant facts, Laventhol made a judgment as to how those facts should be treated. While giving effect to the two transactions as a purchase and sale in its audit report and audited financial statements, Laventhol's judgment was that the $2,030,500 in anticipated profits could not be taken into income for the eleven month period ending November 30, 1969. Accordingly, Laventhol required that Firestone Group reflect as income for the period only the amount of $235,000 which represented the $25,000 paid by Continental when the contract was signed the further $25,000 due from Continental on January 2, 1970 (841-845a) and the $185,000 in liquidated damages provided for in the contract of sale (145e). The remaining $1,795,500 of anticipated profit appeared in the balance sheet and income statement as "deferred" income. Laven-

* All references designated by the letters "a" and "e" refer to the joint appendix, the former designation being to the first four volumes and the latter designation to the last two volumes.

thol also appended an explanatory footnote to this "deferred" item and qualified its opinion to indicate that it was "subject to the collectibility of the balance receivable on the contract of sale (see Note 4 . . .)" (32e)

The Note and Stock Purchase Agreement sent by Firestone Group to the investors in this private placement contained unaudited financial statements and provided that confirmation of these statements by audited financial statements was a condition of closing. The testimony of Richard Firestone, Firestone Group's president, Lee Meyer both an officer of Firestone Group's Underwriter, Allen & Company, Incorporated ("Allen") and a director of Firestone Group, and Robert Feinberg, Firestone Group's attorney, was that the audited statement did not conform. (713-716a, 801-805a, 970-978a, 980a). The issuer then tried desperately to get Laventhol to change its view and recast its opinion to treat the income more favorably. Laventhol refused, knowing that the nonconformity could well explode the private placement (801-805a, 893-895a, 941-942a, 973a). This nonconformance instead precipitated an "explanatory" letter from Firestone Group to the investors after the closing, in which the issuer misleadingly attempted to minimize the differences between the Laventhol report and the unaudited figures, and offered rescission of the Agreement (28-30e).

C. The Holding of the District Court as Regards *Scienter*

The District Court, ruling before *Hochfelder,* found *scienter* on the part of Laventhol, based on Laventhol's knowledge of certain audit facts, which the District Court held should have been discursively disclosed in its report. However, the District Court did *not* hold that Laventhol intended its report to be misleading but only stated that "[t]he evidence, thus, clearly demonstrates that Laventhol had actual knowledge of the omitted facts which render its report misleading." Therefore, the District Court's basis

for finding *scienter* on Laventhol's part was the existence of audit facts and the nondisclosure *of those facts* alone.*

D. The Decision of the Panel

The panel significantly departed from the analysis of the District Court in respect of the supposedly misleading character of the Laventhol report. Whereas the Court below found that the report was misleading for failure to recite a catalogue of facts from which an investor might infer that the Monterey transactions were not what they seemed, the panel of this Court concluded that the Monterey transactions were indeed not what they seemed and that their inclusion at all as an economic event rendered the financial statements misleading. The panel specifically rejected the notion that the audit facts mentioned by the District Court needed to be included in the report. The panel said:

> "In sum, we affirm the result reached by the Trial Court in holding that the Laventhol report contained materially misleading omissions and misrepresentations. The term 'result' is used advisedly. Although we agree with the facts as found by the Trial Court, we do not accept its opinion that all of the ten items specified therein were required to be included in Laventhol's report. The vice of the report was its representation that the Monterey transactions were consummated and the concomitant statement that current and deferred profit had been realized. This would have been remedied by simply not recognizing the sales as completed transactions for the accounting period ending November 30, 1969. A specific listing of the facts which dictated that treatment would have been unnecessary." (Slip Op. pp. 23-24)

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* The District Court found further evidence of Laventhol's knowledge of these facts in its qualified opinion and certain workpapers. In neither case did the Court find intent to deceive—merely evidence of factual knowledge.

The Court apparently overlooked the impact of this changed analysis on the *scienter* element of the case. For the District Court found *scienter* in the knowledge that Laventhol possessed of the audit facts which it obviously had not recited in its report. The District Court then was able to infer that the omission of those known facts was "knowing". Whatever that analysis might lack as a matter of law, it was at least consistent as a matter of logic.

The panel, however, agreed with Laventhol that a recital of audit facts was unnecessary. The panel found the critical flaw in Laventhol's report in the accounting judgment which Laventhol arrived at in light of those audit facts. Laventhol was, of course, required to make the judgment as to whether the known audit facts (and many others known to Laventhol and not reiterated in the opinion) justified the recognition of the Monterey transactions in the current period. Laventhol made that judgment and the panel held that the judgment was wrong.

But it does not follow from Laventhol's knowledge of certain audit facts that the judgment which it made was made in bad faith; and it was the *judgment* reflected in the financial statements which the panel found to be wrong.

In short, in order to make out his case, consistent with *Hochfelder,* the plaintiff here was obliged to prove that Laventhol's judgment as to the opinion to be rendered on the financial treatment accorded the Monterey transactions was misleading and was arrived at with an intent to deceive, manipulate or defraud. It is not enough that the plaintiff and the Court disagree with the financial treatment thought to be required by the known audit facts, or by a portion of them. That disagreement leads merely to a conclusion thta Laventhol was wrong in its accounting judgment. *Hochfelder,* however, stands for the proposition that errors of judgment are not actionable under section 10(b) in the absence of an intent to deceive. That intent is absent both from the record and from the District Court's findings and

the requirement that there be such a showing was apparently overlooked by the panel.

The panel's further distinction of *Hochfelder*—that plaintiff there had not alleged *scienter* whereas Herzfeld had—is untenable. *Hochfelder* was decided upon a motion for summary judgment in which the concession of the plaintiffs that they did not allege wilfull fraud was binding. In this case, decided after trial, it is of course incumbent upon the plaintiff not only to plead but to prove the requisite intent to deceive. As suggested by the outline of our analysis above, Herzfeld has failed to do this.

Conclusion

The panel erred in affirming liability against Laventhol on the basis of factual knowledge from which a judgment was drawn with which the panel disagreed, in the absence of any demonstration that the judgment was arrived at in bad faith with an intent to deceive, manipulate or defraud. The establishment of a standard of this character as the first utterance by this Circuit on the *Hochfelder* rule works an injustice in this case and is a dangerous and inappropriate precedent for similar cases. Petitioner submits that the interests of justice and the orderly development of the case law require that the point be reconsidered with the benefit of briefing and argument addressed to the issue.

Dated: New York, New York
August 11, 1976

Respectfully submitted,

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Receipt of 2 Copies of the
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